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SUBJECT: SOARING OIL PRICES RAISE ALBERTA SURPLUS AND OTTAWA EYEBROWS

SUMMARY

¶1. While commuters from New York to Tokyo watched in horror as oil and gas prices shot up this year, residents of Calgary, Alberta celebrated, and for good reason. For every US$1 increase in the price of a barrel of oil, an estimated C$100 million is pumped into provincial coffers. Recent spikes in the value of these commodities have fueled a booming Alberta economy, already the strongest in Canada. However, just as no lottery winner is long appreciated by his neighbors, surrounding provinces have experienced no shortage of surplus envy. The provincial government is therefore faced with the unusual problem of too much money, and too many options. This report will survey some of the possible solutions being investigated for this unbudgeted cash, as well as the effect Alberta's newfound wealth has had on intergovernmental and international relations in Canada. End Summary.

Sources of Alberta's Wealth

¶2. As recently as 2004, the Finance Ministry of Alberta predicted that oil prices would fall from the "unsustainable high" of US$31 a barrel to "US$26 per barrel in 2004-05 and US$25 for the following two years." Currently, the price of oil is well over US$65 a barrel, and most economists expect this trend to continue. This unpredicted surge has result in an unbudgeted provincial surplus estimated at anywhere from C$6 billion to C$12 billion. Resource royalties are the largest source of income for the Alberta government, which is expected to take in at least C$14 billion from oil and gas companies in ¶2005. One important factor behind the unbudgeted surplus is that rising oil prices cut down the average time before an oilsands project reaches payout status. Three-fifths of the projects are now in this higher tax bracket, causing royalty revenue from synthetic crude oil and bitumen to come in seven times higher than budgeted.

¶3. While international attention has recently focused on the increasing development of Alberta's huge oil reserves, 75% of the province's energy revenues actually come from natural gas. In 2003, Alberta's pipeline infrastructure of 332,000 km delivered 5 trillion cubic feet (tcf) to international and domestic markets. That same year, the province exported 2.6 tcf to the United States, meeting about 12% of American demand. The price of natural gas is historically tied to the price of oil, and at US$14 per thousand cubic feet, is seven times the average price of the 1990's. Alberta is also seeing an increase in its role as a natural gas hub, with gas from the proposed Mackenzie Valley and Alaska gas pipelines set to run through the province on route to markets in the U.S.

Oilsands Seen as the Future

¶4. However, with the vast majority of known natural gas fields already mature, and exploration finding few new sources, Alberta's vast oilsands are seen as the future of the province's resource economy. The 2003 Oil and Gas Journal reported Canada's oil reserves at 180 bbls (second only to Saudi Arabia), an increase from earlier estimates of 4.9 bbls. This increase was due to the recognition of Alberta's oilsands, where oil production had previously been considered uneconomical. A combination of high oil prices and improved refinement techniques have made this resource competitive, as Saudi Arabia and other suppliers of traditional crude oil struggle to increase their own production. Alberta's oilsands production of one million bpd is expected to triple over the next 15 years.

¶5. Not all of Alberta's prosperity can be attributed to winning the resource jackpot, however. The "Alberta Advantage" of low taxes, advanced infrastructure, and a well-educated workforce has drawn in many industries from less pro-business provinces. The value of Alberta's industrial goods increased at an annualized rate of 30% in the first half of 2005, a factor in the 15% surge in total exports. Construction is another booming part of the economy, with the issuing of new permits growing so

fast the national statistics are being inflated. Alberta is by far the wealthiest province in Canada, and with a 4% GDP growth rate this year, the gap is growing. At more than C$45,000, Alberta's per capita GDP is 140% of the national average.

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The Enviable Task of Spending Alberta's Surplus
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¶6. Forecasts of Alberta's 2005 surplus have risen steadily this year, as oil and natural gas prices passed US$50 in July, then hit a record high of US$70.85 in the aftermath of hurricane Katrina. The budgetary infusion this surge has created for Alberta's government has prompted many around the province to submit their own wish lists. Recent proposals have ranged from spending the money on environmental upgrades in the oilpatch to virtually eliminating corporate and income taxes. In an example of why the Liberal Party will likely never form a majority government in the conservative province, prominent Liberal legislator David Swann has suggested that Alberta spread the wealth: "Alberta needs to step up and share," said Swann. "The feds will do what they need to do in the interests of Canada - they don't need to apologize for that." More feasible Liberal measures include eliminating education and health fees. Alberta Premier Ralph Klein, a conservative Tory, has presented a fusion of several approaches to solve the "problem" of the C$6 billion surplus.

¶7. Perhaps most prominent in the premier's new budget is the C$400 "giveaway" he has promised each Albertan, at an estimated cost of C$1.4 billion. While this distribution of oil money may seem familiar to observers of the Alaska Permanent Fund, provincial leaders have been careful to avoid structural similarities. Klein has emphasized that the surplus will not necessarily grow into the entitlement enjoyed by Alaskans, explaining that it is a "one-time investment because we have one-time riches". Surprisingly enough, Albertans have been split over the giveaway, with 48% saying the government should keep the money and use it to address provincial problems, such as rising tuition costs and expensive health care. Dr. Roger Gibbins, President of the Calgary-based Canada West Foundation (CWF), has warned that the giveaway is short-sighted public policy: "We are talking about the responsible stewardship of public funds coming from non-renewable natural resources and in this context the prosperity dividend makes no sense". CWF, a well-known think tank, recently published a report advising that half the surplus be placed in savings accounts and the other half be used for current government programs. The payout has also angered Alberta's municipal governments, with the mayor of Calgary recently publishing a pamphlet accusing Klein of "shortchanging city governments". Klein has also promised broad tax cuts targeted at the long-term growth potential of Alberta's more stable industries, such as high technology and finance. Business and taxpayer groups are petitioning the provincial government to eliminate the gas tax, but at C$.09/litre, Premier Klein argues that any further cuts would only anger neighboring provinces forced to charge much higher rates. One popular proposal supported by the Liberals and NDP would eliminate provincial health premiums, costing the treasury about C$900 million.

¶8. Any plan for using the surplus will include a substantial enlargement of the Alberta Heritage Fund, which acts as an investment service for government money. Past Heritage Fund projects have included the ongoing Foundation for Medical Research, as well as infrastructure upgrades and scholarship programs. Throughout its 29-year history, the fund has generated C$30 billion in investment income for the province. Much of the anger directed at Klein in recent weeks has come from groups frustrated by his "lack of long term vision," and tenuous support for the Heritage Fund. The Calgary Chamber of Commerce called such programs as the C$400 payout as "ill-conceived, short-sighted and compromising to Alberta's prosperity." Such feelings are common in Albertans who remember the disastrous National Energy Program of the early 1980s, when federal raids on resource revenue turned the last oil boom into a recession, and put up to 15% of Albertans out of work. It remains to be seen whether the premier will heed calls for a long-term commitment to the Heritage Fund.

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Alberta Reacts to Eastern Canadian Calls to "Share the Wealth"
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¶9. In the same month that Albertans are celebrating the latest oil boom with a spending spree, other provinces continue in a persistent economic slump. Even Ontario, traditionally one of the wealthiest provinces in Canada, recently published a study warning Ottawa that it is danger of becoming a "have not" province. A number of different provinces have called for a reevaluation of the equalization formula, which ensures standardization of services across Canada by redistributing funds from wealthy provinces (Alberta, Ontario) to the less-fortunate (everyone else). Currently, the formula averages

the per capita income of the middle five provinces to determine appropriate levels of distribution. However, many in Quebec and Ontario are now petitioning Ottawa to include Alberta, by far the richest province, into this equation. If the Council of the Federation succumbs to this pressure, Alberta would become the sole "have" province, causing the equalization burden for 30 million Canadians to fall on three million Albertans.

¶10. Not surprisingly, this idea has not been popular with Albertans, who already send C$3,500 per capita more to Ottawa than they receive in services every year. Klein has repeatedly warned other provinces to "keep their hands off" Alberta's resource revenues, which the provincial government owns under the authority of the Canadian Constitution. The increasing antagonism between Alberta and eastern provinces has fueled isolationist attitudes in the already conservative province, with 41% of Albertans supporting independence talks. It is highly unlikely that a local separatist movement will ever reach the levels of popular support enjoyed by the Bloc Quibecois, but these numbers have alerted the central government to the ongoing alienation felt by the western provinces. As the Lethbridge, Alberta Citizen Society Research Lab member Dr. Faron Ellis has warned, "Canadians across the country should be aware that if these are the bedrock levels of frustration without a crisis, the next crisis (will have) westerners at least debating the concept."

Premier Klein Prepares for "Goodwill" Tour of Eastern Canada

¶11. Current antipathy towards Alberta has been growing throughout the 1990's, as neighboring provinces have watched a demographic shift as many of the youngest and brightest across the Confederation move to booming metropolises such as Calgary and Edmonton. This trend will likely continue, as high wages and severe labor shortages across Alberta draw in job seekers. To allay fears of this growing prosperity, Premier Klein will embark on a goodwill tour of eastern Canada later this year. The central theme of his trip will be to remind easterners that Alberta already does more than its part, contributing C$10 billion every year to other provinces through equalization. Furthermore, a recent study by the Calgary-based Canadian Energy Research Institute (CERI) found that, with 41% of tax revenue generated by Alberta's energy industry, Ottawa was the biggest winner from high energy prices. The study also projected that over the next 15 years, more than six million person years of employment will be created by the booming oilsands; half of it will be in other provinces, especially in the manufacturing sector of Ontario's economy. Unfortunately for Edmonton, these reminders may not be enough to assuage jealousy in eastern cities struggling with record budget shortfalls.

Alberta Has a Friend in Imperial Oil CEO

¶12. This antipathy was touched on by Imperial Oil's Chief Executive Officer Tim Hearn in a speech to the Calgary Chamber of Commerce on October 6. Hearn, who moved Imperial's head office from Toronto to Calgary this summer, predicts that Alberta's current energy-driven prosperity is more than just an oil boom. With global consumption of all forms of energy forecasted to rise by 50% over the next quarter century, it is likely that current high oil prices represent not a spike, but a new price plateau. According to Hearn, Alberta's 1.7 trillion barrels of bitumen represent the last large, undeveloped, non-renewable energy resource in G-7 nations. As developing nations strive to break age-old cycles of poverty, the inevitable increase in energy demand will provide lasting prosperity to Alberta, and to all Canadians.

¶13. Echoing many of the sentiments Premier Klein has voiced in recent months, Hearn pointed to the Calgary-based Canadian Energy Research Institute (CERI) study to argue that unrestrained prosperity in Alberta is good for the entire Confederation. CERI estimates put the amount of economic spin-off from the oilsands development at C$1 trillion between 2000-2020, with a large portion occurring outside Alberta. For every two jobs created in Alberta, there is an additional job elsewhere in Canada. Additionally, Hearn reminded Canadians that oil prices are highly cyclical, and today's "boom" could easily be tomorrow's recession, as Albertans, Imperial Oil employees in particular, know so well.

A Tax Grab by Ottawa on the Way?

¶14. While the Canadian Constitution states that Alberta's resources are the property of the provincial government, a number of methods through which the federal government could increase its take have been proposed. Prominent among them is an increase in the carbon tax, which already costs Canadian

companies an estimated C$9 billion dollars a year, the bulk of it from Alberta. This would also be a popular move with environmental lobbying groups, which have been angered by Alberta's rejection of the Kyoto Protocol. A more questionable move legally, nationalization of the oil industry is favored by almost half of Canadians. However, it is highly unlikely that this radical buyout and the resultant "made-in-Canada" pricing will take place, as it would virtually bankrupt Ottawa. Furthermore, current exploration and development efforts cannot be sustained without massive infusions of private monies.

Comment

¶15. Fluctuating resource prices make projections of Alberta's economic future difficult. However, continued development of the oilsands makes it certain that the province will increasingly play an important role in the North American energy market. Ottawa is beginning to see the exports of its richest province as a bargaining tool, with 61% of Canadians favoring limits on oil exports to punish the United States for perceived infractions of NAFTA statutes in the ongoing softwood lumber dispute. While Canadian Ambassador to the United States Frank McKenna rules out closing down Alberta pipelines, he advises that booming oil exports could be an "important card" in future trade disputes. A healthy Alberta energy industry continues to be vital to the well being of the American economy, as oil and gas prices continue their seemingly unstoppable rise to new heights.

¶16. This cable was drafted by our fall intern David Dill.

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